// DEAL POINTS

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# PRACTICAL IMPLICATIONS OF THE SEC'S AMENDMENTS TO THE TENDER OFFER BEST-PRICE RULE

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The recent amendments to the tender offer "best-price rule" – which addressed a significant deterrent to the structuring of transactions as tender offers – became effective on December 8, 2006, and, since that time, the number of U.S. M&A transactions structured as tender offers already appears to be on the rise. Not only have there been more tender offers during the few months following the rule's effectiveness relative to the same period last year,[2] but also practitioners structuring M&A transactions appear to be discussing the tender offer alternative with a renewed frequency that has not existed for quite some time.

This article reviews the background of the rule, describes the recent amendments and includes suggestions for compliance. This article then discusses certain practical implications of the rule, including some considerations for effecting transactions as tender offers or exchange offers in light of the expected increase in M&A transactions so structured.

## I. Background.

The SEC adopted the best-price rule for tender offers 20 years ago to help address unfair and discriminatory practices in the pricing of tender offers. Prior to its recent amendments, the best-price rule (Exchange Act Rule 14d-10(a)(2) for third-party tender offers) provided that no bidder shall "make a tender offer unless: . . . [t]he consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer." Although the best-price rule extends

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[2] *Source:* Bloomberg.

to tender offers by issuers for their own securities,[3] the controversy surrounding the rule's application has arisen principally in the context of third-party tender offers.

Over the years, various payment arrangements between the bidder and security holders of the target company have been challenged as disguised tender offer consideration that violates the best-price rule. The most common types of challenged arrangements have involved the grant or acceleration of stock options and other incentive award payments, "golden parachutes" and other change-of-control agreements, non-competition agreements, and other standard employment arrangements, or modifications to such arrangements. The plaintiffs in these lawsuits also have attacked commercial arrangements, such as product distribution agreements, involving target company security holders.

In deciding these challenges, federal courts generally applied two different tests. Courts applying the so-called "integral-part test" ruled that the best-price rule applies to all integral elements of a tender offer, including compensatory and commercial arrangements that are deemed to be part of the tender offer, regardless of whether the arrangements are executed and performed outside of the time that the tender offer formally commences and expires. Other federal courts used a "bright-line test" that applies the best-price rule solely to arrangements executed and performed between the time a tender offer formally commences and expires. Under either test, however, a bidder that violates the best-price rule may be liable to pay the highest per-share value of the offending arrangement to all security holders. The per-share value could amount to a significant multiple of the announced tender offer price, especially if the recipients of substantial payments hold only a small portion of the shares eligible to be tendered.

In view of this potentially significant liability and the conflicting judicial interpretations regarding the reach of the best-price rule, many parties to business combinations refrained from structuring their transactions as tender offers prior to the recent amendments. Instead, particularly where the retention of employees or the execution of severance or other compensatory arrangements have been important to the transaction, buyers have elected to complete their acquisitions as one-step mergers, which are not subject to the best-price rule, even when a tender offer otherwise might have been a more advantageous structure.

## II. Amendments to the Best-Price Rule and the Safe Harbor.

In fashioning the amended rule, the SEC specifically declined to endorse the approach of either the integral-part test, which it believed would be too expansive, or the bright-line test, which it believed would compromise the protections of the rule by limiting its application to an artificially defined tender offer period. Instead, the amendments reflect the SEC's position that the best-price rule should apply solely to consideration paid for securities tendered in the tender offer and should not encompass other payments to securities holders that were not made to acquire their securities.

[3] *See* Exchange Act Rule 13e-4(f)(8)(ii).

***Revisions to the Best-Price Rule***. The amendments revise the best-price rule for both third-party and issuer tender offers to provide that a bidder may not make a tender offer unless "[t]he consideration paid to any security holder *for securities tendered in the tender offer* is the highest consideration paid to any other security holder *for securities tendered in the tender offer*." The clause "for securities tendered in the tender offer" replaces the clauses "pursuant to the tender offer" and "during such tender offer," respectively, in the old rule. This change clarifies that the best-price rule applies only to the consideration paid for securities tendered and does not apply to consideration paid for other purposes, such as under compensatory arrangements.

***Exemption for Certain Arrangements***. Recognizing the concerns raised by the best-price rule's potential application to compensatory arrangements, the SEC supplemented the foregoing amendment by adding new Rule 14d-10(d)(1) for third-party tender offers and new Rule 13e-4(f)(12)(i) for issuer tender offers. So long as two conditions are met, the new provision will exempt from the best-price rule the "negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement, or payments made or to be made or benefits granted or to be granted according to such an arrangement, with respect to any security holder" of the target company. To qualify for the exemption, the amounts payable by the covered arrangement must:

- be paid or granted as compensation for (i) past services performed, (ii) future services to be performed or (iii) future services to be refrained from being performed (as in the case of a non-competition agreement) by the security holder, and matters incidental to the foregoing; and

- not be calculated based on the number of securities tendered or to be tendered in the tender offer by the security holder.

The SEC also made a number of changes to the exemption based on comments to its proposals. In one change, the SEC expanded the proposed exemption for compensatory arrangements entered into with employees or directors of the target company to include compensatory arrangements entered into with any security holder of the target company. The SEC also expanded the proposed exemption (and the safe harbor discussed below) to encompass issuer tender offers in addition to third-party tender offers. The latter change eliminates uncertainty that might have developed if the SEC had not specifically addressed issuer tender offers in these exemptions.

***Safe Harbor***. The SEC rounded out the exemption for compensatory arrangements by adding a non-exclusive safe harbor in new Rule 14d-10(d)(2) for third-party tender offers and new Rule 13e-4(f)(12)(ii) for issuer tender offers. The safe harbor provides that employment compensation, severance and other employee benefit arrangements will be exempt from the best-price rule if they are approved solely by the target company's (or issuer's) independent directors. The safe harbor also will be available in a third-party tender offer if the compensatory arrangements are approved by the bidder's independent

directors (if the bidder is a party to the arrangements). The comparable safe harbor for issuer tender offers applies if the compensatory arrangements are approved by the independent directors of the issuer's affiliate (if the affiliate is a party to the arrangements).

Under both safe harbors, the arrangements must be approved either by the approving entity's compensation committee or by a committee that performs similar functions. If the approving entity does not have such a committee, or if the members of those committees are not all independent, compensatory arrangements will be exempt from the best-price rule if they are approved by a special board committee composed solely of independent directors formed to consider and approve the arrangements.

To determine the independence of directors serving on the approving committee, a company with securities listed on a registered national securities exchange must use compensation committee independence standards as defined in the applicable listing standards. A non-listed company must use a definition of independence of a selected securities exchange and must apply the definition consistently for all committee members. The SEC also added a helpful instruction to the safe harbor indicating that a determination by the approving entity's board of directors that each member of the approving committee is independent in accordance with the provisions of the safe harbor will satisfy the safe harbor's independence requirements.

Foreign private issuers may have the compensatory arrangement approved by any or all members of the board of directors or any board committee of the approving entity authorized to approve the arrangement under the laws or regulations of their home country. These issuers also will have the flexibility to determine director independence in accordance with the U.S. listing standards described above. The SEC acknowledges and accommodates for the fact that foreign private issuers may not have compensation or similar committees and may not be subject to the independence provisions of U.S. listing standards.

***Complying with the Amended Rule, Exemption and Safe Harbor.*** While the amendments, exemption and safe harbor taken together are well-designed to achieve the desired effect, plaintiffs may nonetheless choose to focus their efforts on tender offers that do not strictly comply with such provisions. As such, parties must carefully consider and strictly comply with the amended rule, exemption and safe harbor in effecting transactions as tender offers. A few examples to illustrate certain possible concerns and pitfalls:

*Adequacy of Approval Process*. It is critical that the compensation committee (or other appropriate independent committee) properly approves the employment compensation, severance or other employee benefit arrangements in question. In this regard, the SEC's adopting release indicates that directors would need to have knowledge of the specific arrangements and the related tender offer when their approval is given. In other words, directors should approve the arrangements in connection with a pending transaction after considering the safe harbor, since mere advance approval of a

compensatory arrangement (*e.g.*, routine board approval of an incentive plan or an employment agreement outside the context of an offer) may not suffice.

*Ensuring the Target's Compliance*. In addition to the need for targets to carefully comply, bidders should monitor and ensure such compliance. In that regard, bidders may wish to review target board resolutions and obtain specific representations and warranties and covenants regarding compliance. Indeed, even though the revised rule has only been effective for a few months, a number of tender offer merger agreements have already included such provisions.

*Conditional Arrangements*. While the amendments strive to eliminate certain unintended consequences of the rule's application, its basic tenets still apply. Accordingly, certain arrangements must be carefully tailored to avoid falling back into the rule's prohibitions where the availability of the exemption will be lost. In that regard, the SEC's adopting release notes that conditioning arrangements on a security holder tendering in the tender offer would most likely violate the amended rule, but merely conditioning arrangements on the tender offer being completed (without any requirement to tender) should not be problematic.

*Non Tendering Shareholders; Other Rules*. While the best-price rule is not applicable to shareholders who do not tender, that fact by itself is not a license to enter into arrangements with non-tendering security holders. For example, if the arrangement involves some type of consideration for shares, Rule 14e-5 – which prohibits purchases outside the tender offer – may nonetheless apply.

## III. Practical Implications of the Amended Best-Price Rule.

***Increase in Consensual Tender Offers***. The most notable ramification of the best-price rule amendments is the expected resurgence in tender offers. This is the case because the risk of litigation with respect to employee benefit arrangements should be significantly reduced under the new rules, thus making tender offers again an attractive acquisition method. As a result, more parties already appear to be giving greater consideration to the advantages of using tender offers relative to one-step mergers, some of which are discussed below.

***Timing Considerations***. With the litigation risks minimized, the principal reason for the attractiveness of tender offers is the timing advantage relative to one-step mergers. Tender offers typically can be completed as quickly as 20 business days after the offer formally begins, assuming no regulatory or other constraints. Moreover, if sufficient shares (90% in Delaware) are purchased to permit a bidder to complete a "short-form" merger, the acquisition of 100% of the target typically can be consummated promptly after the offer is completed.

In addition, the overall SEC review process in tender offers adds to the timing advantage. Under SEC rules, a bidder may initiate a cash tender offer without first filing and clearing documents with the SEC; a merger proxy, on the other hand, typically

cannot be mailed until it has first been cleared. Moreover, in light of the typically more streamlined disclosure documents in a tender offer, combined with the SEC review process occurring while the offer is pending, tender offers often result in a faster SEC process overall than is the case in one-step mergers.

Notwithstanding this timing advantage, a one-step merger structure may nevertheless be preferable if the overall timing of the transaction is dictated by regulatory or other considerations. This is the case because a tender offer (typically along with attendant withdrawal rights) would have to be extended continuously until regulatory approvals are obtained, thereby leaving one of the key hurdles in many M&A transactions – shareholder acceptance – open for an extended period of time. By contrast, in a merger, shareholder acceptance occurs by virtue of the shareholder vote on the transaction, which vote could happen well before receipt of regulatory approvals. In addition to the obvious benefit of overcoming this important hurdle sooner rather than later, obtaining shareholder approval as early as possible in the transaction is an important safeguard against the possibility of losing the deal to a competing acquisition proposal (since such possibility would typically terminate once shareholder approval is obtained).

***Ability to Effect a Short-Form Merger***. As noted above, a key component of the tender offer timing advantage is the ability to effect a "short-form" merger, and thereby acquire 100% of the target company promptly following expiration of the initial 20 business day period. Should a bidder fail to acquire the requisite number of shares for a short-form merger (90% in Delaware), it may nonetheless acquire the tendered shares and own less than 100% of the company. While a tender offer would typically contain a minimum condition such that following the offer, the bidder would be vested with sufficient shares to control the outcome of a shareholder vote on the second-step merger, the process of preparing a disclosure document and calling a meeting to vote on a merger whereby the bidder would acquire the remaining untendered shares could take months – in other words, close to the timetable had the transaction been structured as a one-step merger. That said, absent shareholder opposition to the transaction, in a tender offer where the minimum condition is satisfied, it would be unusual for the bidder not to also be able to obtain sufficient shares to effect a short-form merger.

***Maximizing the Ability to Effect a Short-Form Merger.*** In light of the importance of being able to effect a short-form merger, the bidder will often include a permitted subsequent offering period (during which withdrawal rights do not apply), pursuant to Rule 14d-11, following the consummation of the tender offer. The rationale is that shareholders that have not tendered into the offer, when faced with the prospect of receiving promptly the same consideration if they tender during the subsequent offering or receiving it months later following a shareholder approved merger, would typically prefer the former.

Another more increasingly-used feature is the so-called top-up option. Here, the target would grant the bidder an option to purchase additional shares in order to reach the requisite short-form threshold (*e.g.*, 90% in Delaware). This feature can provide a

significant benefit, but nonetheless requires consideration of a number of factors – not the least of which is the potentially large number of shares required to be issued for the top-up option to be effective (in light of the resulting increase to both the numerator and the denominator in any share calculation). As a result, any significant issuances could come up against authorized share limitations in the target's charter and stock exchange shareholder vote requirements.

One recent (and notably less typical) variant of the top-up option would be for the target to grant bidder the option in certain circumstances to obtain the requisite number of shares to obtain mere control (as opposed to 90% for a short-form). Such circumstances could include, for example, if the bidder would have otherwise succeeded in obtaining 50.1%, but for dilution resulting from pre-closing option exercises. The top-up option in this circumstance would require the target to issue sufficient shares to the bidder so that it could obtain the requisite 50.1% merger vote. While this may seem appealing, in addition to the considerations raised by the more typical 90% top-up option, this feature raises a host of additional concerns – most notably, significant fiduciary duty considerations – all of which have likely led to its limited use.

***Appraisal Rights***. In a merger, demands for appraisal under the Delaware statute would typically occur pre-stockholder vote (assuming action is taken at a meeting as opposed to by written consent). Conversely, such demands in a two-step tender offer structure are not due until there is a subsequent back-end merger. As such, while a one-step merger could have a maximum dissenters condition if the circumstances warranted, the Delaware statute would not apply to a tender offer itself. Further, while the risk of appraisal rights in a second-step merger following the tender offer could potentially be minimized via a high minimum condition in the tender offer itself (as tendering shareholders typically could not exercise appraisal rights), such a high condition might not otherwise be appropriate or acceptable in the context of the overall transaction.

***Private Equity Considerations.*** Private equity firms structuring transactions as tender offers will have additional considerations, and, as a result, it remains to be seen whether the expected rise in tender offers will extend (or at least extend as dramatically) to private equity buyers. The most notable of these considerations is compliance with the margin rules. The Federal Reserve Board's Margin Rules prohibit a bank or non-bank lender from extending credit for the purpose of purchasing "margin stock" (generally publicly traded stock) unless the amount of credit does not exceed 50% of the market value of the stock. While this by itself does not preclude private equity buyers from using typical leverage ratios in tender offers, it does drive financing structures towards unsecured bridge loans or more creative structures, such as effecting the transaction by means of a joint issuer and third-party tender offer whereby debt is secured at the target obligor level.

In addition to financing, other considerations include making sure that the applicable transaction and financing structure complies with the private equity buyer's fund documents. Moreover, while the revised best-price rule is designed to address the old rule's unintended application to compensation arrangements, the interplay between private equity compensation arrangements, rollovers or partial rollovers of equity and any

support and/or lock up agreements from shareholders (including, for that matter, in non-private equity transactions) nonetheless warrant careful consideration, including implications under Rule 14e-5 and the ability to effect a short-form merger.

Notwithstanding these additional considerations, a private equity buyer with no regulatory considerations, for example, may be able to use a tender offer to add to the timing advantage that it would likely already have over a strategic buyer with such regulatory issues, thereby making its transaction potentially more attractive to the target company.

***Exchange Offers***. Prior to Regulation M-A going into effect in early 2000, cash tender offers had a clear timing advantage over exchange offers, with exchange offer timing being closer to that of a one-step merger in light of the then-inability to commence an exchange offer until registration statement effectiveness. Regulation M-A changed that requirement so as to permit an exchange offer to be commenced upon filing of the registration statement for the transaction. As a result, while an exchange offer registration statement and related offer documentation are far less streamlined (and thus may take longer to prepare) than cash tender offer documents, the combination of (i) the SEC's willingness to permit early commencement of exchange offers upon filing, and (ii) the commitment from the SEC staff for expedited exchange offer review, should put the two on at least closer footing. Because the "fast track" exchange offer rules came into existence around the same time that the best-price rule was having a chilling effect on tender offers, bidders' reluctance towards tender offers translated into the same reluctance towards exchange offers such that the fast track exchange offer never gained widespread usage. As such, in addition to a resurgence in cash tender offers, an increase in stock-for-stock transactions effected as exchange offers also seems likely.

## Conclusion

The amendments to the best-price rule represent an important step forward in removing a major impediment to the use of tender offers in business combinations where there is payment of compensation to certain security holders. Adoption of the new rules, together with the fact that a tender offer or exchange offer coupled with a short-form back-end merger may be completed more quickly and efficiently than a one-step merger, should result in an increase in tender offers and exchange offers as acquisition structures – something that already appears to be happening.